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Morningstar retirement bootcamp

Webinar 1 - Everything you wanted to know about ETFs and were scared to ask

Webinar 2 - Traditional passive ETFs

Webinar 3 - Thematic and factor ETFs

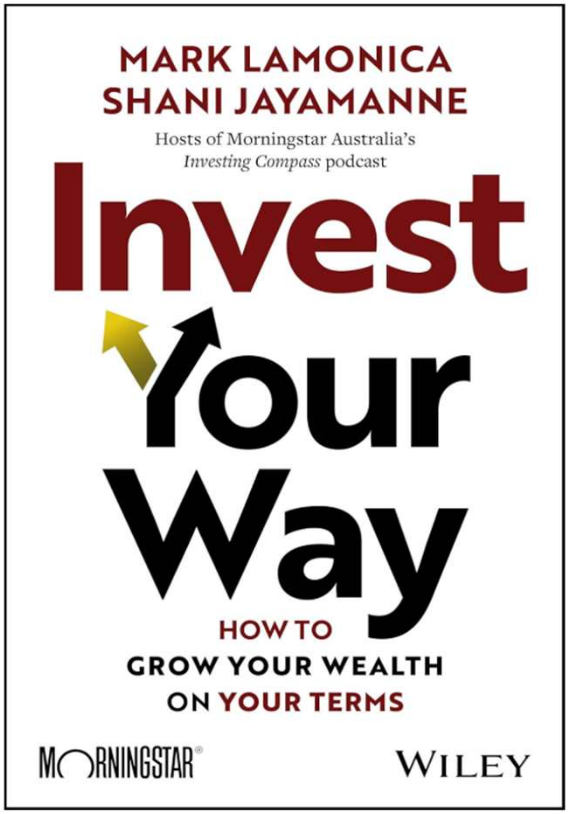
Webinar 4 – Building a portfolio with ETFs

What an ETF is and isn't

- An ETF is not an investment strategy
- An ETF is not an asset class
- An ETF is not a 'simple' investment

- An ETF is simply a wrapper
- What matters is what the ETF holds
- They can be simple or complex, diversified or concentrated, cheap or expensive

Getting the foundations right



- The biggest issue many investors face is undermining their own outcomes by letting emotions influence decision making and making mistakes
- ETFs exacerbate these tendencies given the ease of trading, the proliferation of new ETFs and compelling marketing based on recent performance
- The key is adding structure to decision making by establishing goals, setting an investment strategy and developing a process to guide decision making

How your money is safeguarded

Many investors are understandably nervous about misappropriation of their funds by the fund manager that runs an ETF. All regulated investments funds including managed funds and ETFs separate the safekeeping of assets from the investment activities.

Fund manager: Responsible for directing investment activities. No access to cash or underlying assets.

If a fund manager goes out of business the client funds will not be impacted. Either another fund manager will take over the ETF or the assets will be liquidated and returned to the investors in the ETFs.

Custodial bank: The actual assets – cash and securities – are held by a custodial bank. The bank is responsible for the safekeeping of the assets.

If a custodian were to go bankrupt the creditors of the custodian would not have access to the ETF assets and they would be liquidated and returned to the investors in the ETF.

Example of fund managers: Vanguard, Betashares, Blackrock (iShares), Van Eck

Examples of custodial banks: JP Morgan, Citi, Northern Trust, State Street

How an ETF works

Before ETFs However, were two structures for collective investment vehicles:

1. **Closed-end funds or LICs which trade on an exchange.** The advantage of this structure is that it is easy for investors to trade since they are on an exchange. However, prices are driven by supply and demand like a share and their may be a sizable difference between the net asset value of the basket of holdings and the price of the closed-end fund / LIC unit price.

2. **Open-end funds or managed funds which don't trade on an exchange:** The advantage of this structure is that the price of the net asset value of the basket of holdings and the price of the open-end / managed fund will always be the same. The disadvantage is that you can only transact at the end of the day directly through the managed fund company.

The goal was to create a product that trades on an exchange which allows investors to transact at the net asset value

How an ETF works: A hypothetical ETF with two shares

Hypothetical ETF: NAV of $196.73
1 share CBA $157.13
1 share BHP $39.60

More buyers drive up the price to $200 per unit	More sellers drive down the price to $192 per unit
• The ETF is now worth more than the shares that are held in it. The authorised participant / market maker buys 1 share of CBA and 1 share of BHP for $196.73 creates an ETF unit and sells it for $200. • This same process will happen again and again until enough of the ETF is sold to drive the price down to the NAV where it is no longer profitable for the authorised participant / market maker	• The ETF is now worth less than the shares that are held in it. The authorised participant / market maker buys 1 unit of the ETF for $192, redeems it and sells both shares for $196.73 • This same process will happen again and again until enough of the ETF is purchased to drive the price up to the NAV where it is no longer profitable for the authorised participant / market maker

How an ETF works: Premium / discount

The price of the ETF will never exactly match the NAV however the mechanism of creation units and redemption units will keep it close. There is a cost for the authorised participant / market maker for the creation and redemption process. The less liquid and more volatile the holdings in the ETF the bigger the cost will be and the bigger the premium and discount will be.

How an ETF works: Tracking differences

Passive ETFs are designed to track indexes that may contain thousands of securities. This is a challenging endeavour for the ETF providers. For the most part ETF providers do well but it is impossible to perfectly replicate an index so there may be small differences over time.

Tracking difference is caused by fees, transaction costs, the liquidity of the underlying assets, volatility and the timing of any required rebalancing. For the most part tracking difference is not something that most ETF investors need to worry about.

How an ETF works: What happens if an ETF closes

ETFs close more frequently than many investors believe. In 2024 in the US, over 700 ETFs were launched and around 200 were closed. In Australia in 2024, Betashares reported that 30 ASX ETFs closed last year, representing around 8% of the ETFs on the market at the time.

Most closures occur in more niche products. If an ETF closes, the assets are liquidated and returned to investors. This can have tax consequences as capital gains from the asset sale are passed along to the investors.

Types of ETFs: Active ETFs

ETFs come in both active and passive forms. Passive ETFs track a wide variety of indexes from comprehensive broad-based indexes to more niche offerings. Active ETFs are benchmarked against indexes but make active decision on what and when to buy and sell.

There are several considerations when deciding between an active and passive ETF but data is helpful. Morningstar's Active/Passive Barometer is a semiannual report that measures the performance of US active managers against their passive peers within different categories. Over the 10 years through 2025, **only 21% of active funds both survived and beat comparable passive funds.**

Considerations:

- How efficient is the underlying market?
- How large is the fee hurdle?
- How representative is the index to the opportunities an active manager can access?
- How liquid are the underlying assets?

Types of ETFs: Core ETFs

These active and passive ETFs are the building blocks of your portfolio. The active ETFs benchmark against broad market indexes and the passive ETFs directly track them. Examples of broad market indexes include the S&P 500, ASX 200 or MSCI World index.

Core ETFs make up the foundation of many portfolios and typically would represent the bulk of a portfolio. As a result, it is critical to ensure your core is aligned with your goals and your investment strategy.

Types of ETFs: Factor / Thematic ETFs

Factor ETFs filter investments based on 'factors' or different characteristics. They usually focus on historical drivers of return – such as value, quality, momentum, low volatility or yield. Factor indexes are rules based – they have a set number of criteria that are used to determine whether a security deserves a place in the portfolio.

The purpose of these ETFs are to offer you certain exposure in your portfolio in a systematic way which may be a way to outperform the market and may achieve a different objective.

Thematic ETFs focus on trends and themes that get investors talking. They focus on specific sectors of the market (such as technology) or themes (such as Artificial Intelligence or clean energy).

Thematic ETFs offer the ability to home in and increase exposure to a particular sector, whether it be non-cyclical industries that may have more predictable dividends or technology that is under-represented in Australian broad market index ETFs.

Over 60% of thematic ETFs have shut down in the past 15 years and only 9% of funds surviving and outperforming in the three years to June 2024. Over the past five years, thematic funds had a total return of 7.3%, while investors only earned a 2.4% return.

Types of ETFs: Multi-asset ETFs

Multi-asset ETFs offer investors simplicity without sacrificing diversification. These ETFs blend multiple asset classes into a single ETF. They have exposure to Australian and international equities, fixed interest, commercial property, cash, alternative assets and more. Some are static (for example, 60% equities, 40% bonds) while others adjust dynamically based on prevailing market conditions.

These ETFs give you a near-complete portfolio in one product – but it is just like buying any product off the shelf. These ETFs are not completely customised to what you are trying to achieve, and the fund may mandate future decisions that may not be in your best interests. However, they offer investors simplicity and a hands-off approach where the fund will automatically adjust for risk and rebalance at set intervals.

Types of ETFs: Geared / leveraged ETFs

A geared / leveraged ETF amplifies the upside or downside of returns from a basket of securities. This is either done through the ETF borrowing money or the use of derivatives. These ETFs typically charge higher fees and are designed for short-term traders and can suffer from volatility decay which means long-term returns may differ meaningfully from the ETF objectives.

How an ETF works: Misnomers about ETFs

All ETFs are passive, and all managed funds are active: ETFs and managed funds both come in active and passive varieties.

ETFs pay dividends: ETFS pay distributions which include both income and capital gains from changes made to the portfolio. There can be a meaningful difference between income earned by an ETF and distributions for actively managed, thematic and factor ETFs.

Passive ETFs will match the return of an index: The return of a passive ETF will not perfectly match the underlying index with the difference known as tracking difference when looked at over a specific holdings period. During specific market conditions the differences can vary and is known as tracking error. More liquid indexes will experience less tracking error.

All ETFs are tax efficient: Investors tend to conflate the benefits of passive investing with ETFs. Broad index tracking ETFs are generally tax efficient however many factor and thematic ETFs have high turnover which limits tax efficiencies.

Investing in a bond ETF is the same as investing in a bond: Bond ETFs that hold a portfolio of bonds and constantly refresh that portfolio are not the same as investing in a bond. There is no maturity for the ETF and interest income will vary based on the changing nature of a portfolio.

How an ETF works: Misnomers about ETFs (continued)

ETFs are 'better' than other investments: There are two misnomers here – the first is that an ETF is an investment and the second is that ETFs is the best choice for all investors. An ETF is an investment vehicle and what you are investing in is the underlying holdings in the ETF. All investment vehicles (ETFs, LICs, managed funds) have certain positives and negatives that suit different types of investors. There are studies that suggest investors in passive ETFs and ETFs in general earn lower returns than investors without them because of behavioural risk.